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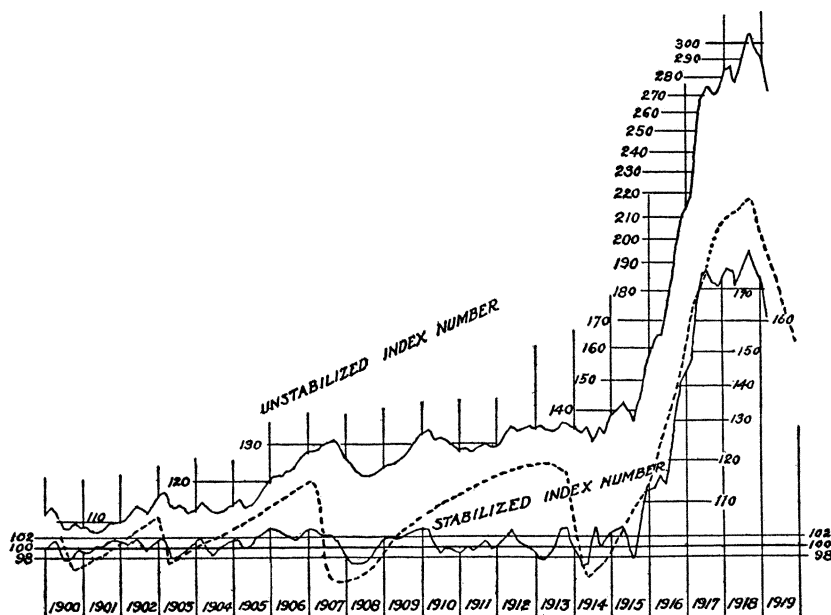
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## A "STABILIZED DOLLAR" WOULD PRODUCE VIOLENT CHANGES IN PERIODS OF FALLING PRICES

Professor Fisher's new book, *Stabilizing the Dollar*, brings under one cover much of the material he has presented in numerous papers and develops the argument for his plan in such persuasive form that the reader can hardly escape regretting his inability to be converted. The evils of changing prices are so vividly portrayed, the mode of escape so logically presented, that the care-worn student of the phenomena of prices would fain accept the analysis. The book is in a class with Henry George's *Progress and Poverty* in the matter of winning exposition; and to say that is near the height of praise. But, if one is more concerned with understanding than with peace of mind, the very clearness of the explanations, the simplicity of the plan, and the confidence in its effectiveness awaken caution and enjoin care in the attempt to forecast what the effect of the plan would be in the economic circumstances under which it would have to be put into operation if it became a working reality.

The writer desires to call attention briefly to the phase indicated in the title of this paper, *i.e.*, the probability that if Fisher's plan were in operation the periods when prices are falling would be marked by sharp drops in money values that would be disastrous to many lines of business and would increase the distress that goes along with depressions in the recurring business cycles.

Professor Fisher presents on page 204 of his book a diagram illustrating the movement of the index number with and without stabilizing according to his plan. This diagram is reproduced here with an additional *conjectural* line indicating what the writer believes would be something like the movement of price changes under Fisher's plan in actual operation with the commercial banking practices as they are in common operation. Instead of the fairly even "stabilized index number" line or the irregularly rising "unstabilized index number" line, there is reason to believe that the actual course of prices would be somewhat as shown by the intermediate line. No attempt has been made to calculate the precise movements of such a line. All that it suggests in an exaggerated degree is that periods of rising prices in times of prosperity would be followed by abrupt declines in prices when depression sets in. The declines that are the normal results of reaction would be greatly increased in speed by Fisher's plan and



In the diagram the upper curved line, reproduced from Fisher's *Stabilizing the Dollar* (p. 204), shows the actual movement of prices, while the lower curved line shows the movement of prices that Fisher believes would have taken place had his plan been in operation. The dotted line is conjectural, meant merely to illustrate the probable violent falls in prices that would occur were Fisher's plan operating in the recurring periods of decline from prosperity to depression. No attempt has been made to calculate the dotted line to scale. It doubtless exaggerates the violence of the probable fall and is unduly smooth.

the difficulties of readjustment would be more serious. Business mortality would rise, failures multiply, and opportunities for mitigating disaster by spreading the losses over the community would lessen. The level might not rise as high as in the case of unstabilized prices, hence the distance of the fall might be shorter but the descent would be more abrupt, less subject to control. Instead of a fairly stable price level there would have been experienced in the period covered by the table a somewhat lower level in the peaks of prices and a more violent collapse as periods of expansion passed into contraction. The paragraphs which follow attempt to make clear the reasons for anticipating more trouble from the operation of Fisher's plan than it professes to be able to cure, granting that it could be set going as he so ably outlines it.

Fisher's plan is doubtless too well known to justify taking the

reader's time to restate it. A summary of its maturer form will be found on pages 104-105 of the volume. Its essential features are the adoption of a representative assortment of commodities worth at the outset a gold dollar of the present weight; the establishment of an "index number" for recording, at stated intervals, the market price of this ideal goods-dollar in terms of the gold bullion dollar; the adjustment of the weight of the gold bullion dollar at stated intervals, each adjustment to be proportioned to the recorded deviation of the index number from par. This constant process of adjustment would keep the purchasing power of the dollar about equal to the value of the representative assortment of commodities. The deviations above and below par would be negligible.

"In addition to these features of the plan should be mentioned the tacit assumption that we retain a sound banking system. Without such, the effectiveness of the stabilization plan would be quite lost" (p. 105).

The importance of this assumption to the success of the plan is vital. The purpose of this paper is to point out that either certain current ordinary practices of commercial banks are not "sound" and should cease or that Fisher's plan, if workable at all, would produce violent declines in prices when business cycles turned from the peak of "prosperity" downward.

As indicated by the diagram, reproduced above from p. 204, Fisher points out that his plan would not have worked in the period of the Great War. "Stabilization and inflation are mutually incompatible" (p. 227), he points out, though he believes that "in all ordinary wars, there is no need of inflation." Whatever truth or optimism there may be in this belief, the point of importance in this connection is that inflation by the use of bank credit makes the plan ineffective to prevent rising prices.

The process of credit inflation in connection with war finance has been made familiar in discussions too many to mention. The government received credit on the books of the banks in exchange for certificates of indebtedness. These certificates were paid off largely from the proceeds of bond issues. The bonds were bought in great measure by purchasers who obtained credit from banks by using the bonds as collateral. The upshot of this system was that the bond buyers, in many cases, bought not with the savings from their current expenditure but with the borrowed credit of banking institutions. The buying of individuals and institutions

for their own purposes went on as usual. To this buying power was added the buying power of the government created by banks and transferred to the government by the bond buyers. This ordinary buying power of individuals and institutions arises from the goods and services they are offering for sale. They offer to and demand from the market goods and services at the same time with no disturbing influence in the price level. When the use of bank credit creates buying power beyond this ordinary amount inflation appears. When ability to buy arises not from the current offer of merchantable goods or desired services the mechanism is put out of gear. The ability to demand outruns the rate of supply of commodities, and prices rise. When this is the accompaniment of extensions of bank credit to the government in war time we have the type of inflation that is so large a feature in our present price situation.<sup>1</sup> If purchasers of bonds had paid for them out of savings they would have withdrawn themselves from the market as buyers and transferred the purchasing power to the government, thus not disturbing the equilibrium between supply and demand at the existing price level so far as this type of transaction was influential. "In all cases where the amount subscribed is not saved, the Government creates or secures purchasing power without creating any equivalent goods to purchase. . . . All of these methods of war finance . . . are inflation none the less, even when gold redemption has been nominally maintained, and they therefore tend to add to the cost of living" (Fisher, p. 34).

It is doubtless unnecessary to go to greater length in bringing to the reader's attention the two important facts: (1) that Fisher's plan would not prevent prices from rising when credit inflation exists; (2) that credit inflation consists in the creation of buying power by the extension of bank credit not accompanied by the offer of equivalent merchantable commodities on the market.

These lessons of wartime finances and prices are easily learned because they were illustrated on a grand scale. Peace also has its inflations, though less renowned than war's.

In the ordinary processes of business the credit of commercial banks is used to assist in the purchase and sale of marketable goods. It takes the form of short-time notes which are to be paid

<sup>1</sup> The statement above may seem to indicate a belief that inflation is the "cause" of high prices. The writer is not of that opinion as indicated later.

from the receipts from the sold goods. The extension of credit to permit buying is accompanied almost simultaneously by an offer in the market of the salable commodities. The effective demand for goods thus made possible is accompanied by the supply of goods. The equilibrium between supply and demand is not seriously disturbed and the extension of credit has no lifting influence on the general level of prices. As long as commercial bank credit serves this purpose there is no inflation. But this is not the only use to which it is put.

In the course of the economic life of communities and countries there occur opportunities for acquiring wealth through the extension of business enterprises and investment in new ventures. No two occasions are precisely alike, but the general characteristic of all is the chance of gain to those who promptly enter the field. The source of the gain may be the development of new territory, the exploitation of natural resources, the creation of a new manufactured product, the utilization of freshly discovered industrial processes, a favorable relation between expenses of production and the prices of finished products which an exceptional demand such as that of war time creates—any of these offer business enterprise the opportunity to invest capital and secure the promised exceptional profits.

What captains of industry need under these circumstances is command over purchasing power that will enable them to secure the capital equipment required to develop the opportunity that they see open to them. The method of putting into their hands this command over purchasing power, honored in theory, is to have savers transfer their accumulations to these business men, thus postponing consumption and allowing their buying power to be turned to the purchase of capital goods. Manifestly as long as this is the sole method of securing capital for business extensions there is no danger of inflation. The net result is to turn effort from supplying consumers with dispensable goods to the creation of capital instruments for further production without any uplifting effect on the price level. But this process is slow, closely limited at any time, and not responsive enough to enable the enterprisers to seize the chance promptly. Another source is open to them and they are allowed to tap it.

The long and honorable practices of commercial banks has created that community asset called bank credit. That is to say, people have become so accustomed to getting money from the

banks in which they have deposits when they need it that the right to draw from a bank has become equivalent to money for purposes of purchasing in the vast majority of modern transactions. This community asset when used by the banks as indicated above for facilitating the purchase and sale of commodities is of great advantage to the community and the chief source of profit to the banks. The banks are in a sense the trustees for the people, the custodians of this intangible public asset, this faith that moves mountains of salable goods every day in the year. In the banks' hands the common trust has placed the power of increasing or decreasing this purchasing power within fairly wide limits. Upon them rests the obligation to safeguard this public intangible property and at the same time utilize it as fully as circumstances will warrant. To overstrain it or break it down would be to betray a trust. To fail to employ it wisely would be to neglect the service of the people and the advantage of the banks. The advantage to the banks of extending the limits of their credit by increasing purchasing power for borrowers is so evident that they are more likely to err in this direction than in the undue contraction that would unnecessarily hamper the exchange of commodities.

To prevent the unwise extension of bank credit two safeguards have been set up. One is the percentage of reserve that must be maintained against loans and the other is the kind of loans that may be made; the latter requiring that only commercial paper of short maturity be the basis of the loans. The first, the percentage of reserves, stated in figures and readily calculated, has a definite character that has given it a prominence as a standard that is important and serviceable. But as a matter of fact, from the point of view of community interest the second point is deserving of the greatest consideration. The use made of the credit loaned is of more significance than its amount when we are concerned with the problem of inflation. In the matter of the use made of the borrowed credit there is not usually any particular publicity, no very precise standards, considerable ease of concealment, the interest of the bank in extending its volume of business, and frequently little development of the sense of trusteeship on the part of the banker. The question as to the purpose to which the borrowed credit is to be put is often answered with a view to the bank's safety and possible profit rather than to the effect on the general public of the use of this purchasing power.

When the economic situation is characterized by the four ele-

ments suggested above, *i.e.*, energetic captains of industry, exceptionally promising opportunities for profitable enterprise if purchasing power to secure capital is obtainable, the slowness of savers to furnish this purchasing power, and the possibility that commercial banks may use their credit for this purpose rather than for facilitating the sale of marketable goods—when such a situation obtains there is invariably the use of bank credit for the purposes of investment to secure command of capital rather than to facilitate buying and selling goods. The nominal form of short-time loans may be retained, but repeated renewals have the same effect as if the paper were for a prolonged period. The purchasing power created is not used to assist in the offer of salable goods. It goes into the employment of labor to produce equipment or the purchase of equipment which will not produce commodities for the market until a considerable period has elapsed, even years. For the time the same result follows that Professor Fisher notes in the case of the government's borrowing during the war. But instead of the government it is the captains of industry who at this time secure "purchasing power without creating any equivalent goods to purchase. . . . All these methods of . . . finance . . . are inflation none the less, even when gold redemption has been nominally maintained and they therefore tend to add to the cost of living" (Fisher, p. 34).

The recurring periods of business expansion that we call "prosperity" because of the conditions indicated are periods of inflation, of upward moving prices. The difference between this type of inflation and that of the war is one of degree in its connection with prices. In neither case is the inflation the "cause" of higher prices. In both cases the need for more non-salable goods is so imperative that the volume and speed of output must be increased. To overcome any resistance and secure the services and materials necessary, greater expenses are incurred, higher prices have to be paid, and the possibility of increasing the volume of loans enables these prices to be offered. Thus the inflation "permits" rather than "causes" the higher prices. Captains of industry resort to bank credit to secure the additional purchasing power required to call forth the additional quantity of capital goods within the time in which they think they can seize the profitable opportunities to invest and develop. The inflation is thus caused by the necessity for offering higher prices to secure the required goods and services.

During the past the level of prices in booming times has risen on the crest of prosperity and fallen into the trough of the succeeding depression with little opposition or acceleration. If Fisher's plan were put in operation and actually worked, in the period of rising prices the level of prices would not rise unhindered. The position of the line indicating rising prices would be the result of two forces: the expansive force of the boom demand and the retarding influence of Fisher's compensatory device. The latter would act as a check on the rising tendency during the period of inflation so that the rate of rise perhaps would be somewhat less rapid and the peak of prices somewhat less high than they have been in the experiences through which business has hitherto gone. When the period of expansion has passed, under the influence of the compensatory plan, the influences leading to the expansion of prices would cease and instead of the usual rate of fall in depression the influence of the compensatory arrangement working with full force would draw the level of prices down with abruptness. The drop from the high level of the expanded period would be sudden. When a boy flies a kite in a favorable breeze the kite rises on the wind and settles down when the breeze ceases to blow. But if the string holding the kite were elastic it would stretch as the breeze grew stronger and contract when the breeze fell—thus the kite would be drawn down abruptly as soon as the wind's support stopped. In similar fashion Fisher's plan for stabilization would not prevent prices from rising on the winds of a "boom." As soon as the breath went out of the "boom," the compensation plan would draw prices down with a jerk and the rate of fall in a period of reaction to depression would be greatly accelerated.

The collapse of the price structure following the turn from "prosperity" would make it extremely difficult and often impossible to make business adjustments. The problem is bad enough now. Fisher's plan would make it very much worse. Changes that are not too sudden may be met by careful planning, but abrupt declines would fall heavily on the enterprisers, bringing financial ruin to them and disorganization to the community in general.

Professor Fisher's explanation of trade cycles (p. 65) on the theory that "price fluctuations cause alternate fluctuations in business, that is, booms and crises, followed by contractions and deduced by the very tax itself), we are involved in circular reason-

Fluctuations in business cause fluctuation in prices, when the situation is not complicated by such a phenomenon as war. Subsidiary businesses may be stimulated by higher prices but these in turn are due to expansions in the fundamental businesses which have been stimulated by the hope of exceptional gains in some field of development and exploitation. Fisher declares "it seldom occurs to business men that business thus staggers about because the dollar staggers." There is not sufficient reason why it should. Price changes are a link in the chain of influences that affect the conditions prevailing in prosperity and depression, especially in connection with long-time contracts, ownership of large stocks of goods, and claims for definite sums of money or obligations to pay them, but the price changes are the results of and transmitters of, not the fundamental causes of, the fluctuations between good and bad times.

Unless there is a radical change in the usual course of business and methods of banking the adoption of Fisher's plan is full of peril. It would not prevent price advances while bank credit is used to further investment enterprises and it would result in radical falls in prices when the stimulation of boom times was passing away. Whatever gains might be secured through offsetting changes in prices over a series of years that might be attributed to variations in the value of gold in relation to goods would be more than lost by the evil done through the increased violence of falling prices in the recurring periods of depression that accompany the activities of business enterprise as aided by the use of bank credit.

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